American Petroleum Institute
1220 L Street, Northwest
Washington, D.C. 20005
202-682-8240

G. William Frick
Vice President and
General Counsel

February 5, 1996

David J. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165
MS 3101
Denver, CO 80225-0165

American Petroleum Institute Comments on MMS Proposal, "Amendments to Gas Valuation Regulations for Federal Leases." 30 CFR Part 202, 206, and 211; 60 FR 56007 (November 6, 1995)

Dear Mr. Guzy:

API welcomes this opportunity to submit written comments on the MMS' November 6, 1995 proposal on federal gas valuation. Our written comments incorporate by reference the January 22, 1996 testimony delivered by Mr. George Butler of Chevron, API's principal representative for the regulatory negotiation underlying the MMS proposal. Since many of API's over 300 company members pay royalties on natural gas produced from federal onshore or offshore oil and gas leases, API has a significant interest in this rulemaking.

Overall, API strongly endorses the MMS' November 6, 1995 proposal. API participated heavily in the regulatory negotiation process leading up to the March 1995 Final Report of the Federal Gas Valuation Negotiated Rulemaking Committee ("*Final Report*") and we believe the *Final Report* provides a sound basis for revised regulations offering much needed simplicity and certainty in valuation of gas produced from federal leases. In the specific comments which follow, API addresses certain specific areas where the proposal does not reflect the consensus reached by the Committee. In addition, API's comments address specific questions posed by the MMS in the preamble to the proposal.

1. <u>Royalty on Gas Contract Settlements</u> (Preamble at 60 FR 56011; §206.454(a)(6) at 60 FR 56024).

As proposed, §206.454(a)(6) would require lessees who receive revenue in connection with the reformation or termination of a gas purchase contract, occurring <u>prior</u> to the effective date of the rule, to pay royalty on the increment of revenue attributed by the MMS to future production <u>in addition to</u> any index-based or other /value established under this section. At 60 FR 56024, the MMS also requests comment on whether it should require that royalty be paid on any amounts attributable to gas contract settlements entered into <u>after</u> the effective date of the rule.

Notwithstanding the MMS assertion at 60 FR 56011 that the gas contract settlement issue is "an issue that the Committee did not consider," gas contract settlements were an integral part of the Committee's deliberations and compromise on gas valuation. The negotiated rulemaking process was long and arduous. The negotiated rulemaking record shows that industry participants took the initial position that the existing gross proceeds rule was arcane, unworkable, and legally indefensible, and that index prices were a more precise and manageable measure of the market value of production. MMS and the states, however, would not agree to the option of using indices without two key concessions from industry: (1) the lessee would be required to "true up" its index payments using a safety net median value if its payments fell below such value; and (2) establishment of index as a floor below which royalty value would not be adjusted, even when the lessee's index payments exceeded the safety net median value.

The Committee ultimately agreed that lessees using the index-based method of valuation could have only one additional royalty obligation, a true up payment if index were less than the final safety net median value calculated for a zone. It was the clear understanding of all who participated in the regulatory negotiation deliberations that the royalty obligation ended there. The Committee expressly agreed that royalties paid on pipeline buyout/buydown settlements would not be used in calculating the safety net, *Final Report* at 35, and when the Committee reached consensus on the concept of index plus safety net, the MMS agreed not to assess additional royalties on any other basis. In sum, the hard fought, good faith consensus of the entire Committee was that royalty value is index value plus any true up payment. Notwithstanding this consensus, the MMS in its rulemaking proposal is saying essentially, that royalty value is really index value and any true up payment <u>plus</u> gas contract settlement revenue.

The pendency of litigation challenging the current MMS interpretation of "gross proceeds" in *IPAA v. Babbit* and *United States v. Century Offshore Mgmt. Corp.* in no way undercuts the consensus reached by the Committee. From the very outset of the regulatory negotiation the Committee sought a valuation alternative that offered payor/lessee and lessor alike simplicity and certainty. Every member of the Committee recognized that "gross proceeds" was neither simple nor certain, given the difficulty of tracing remote sales back to the point of production, and that this was especially true for gas contract settlements where allocation of proceeds is especially difficult and controversial.

Likewise, there is nothing inequitable or incongruous about requiring <u>gross proceeds payors</u> to pay royalty on gas contract settlement proceeds (to the extent that such proceeds are held to be royalty bearing) and allowing <u>index payors</u> to disregard proceeds received from gas contract settlements. This is because the index-based valuation method prohibits adjustments in the lessee's favor when the index-based value exceeds the safety net median value. Any revenue attributable to gas contract settlements that MMS and the states would forego on proceeds from gas contract settlements would be offset by index payments that exceed the safety net median value.

Stated simply, §206.454(a)(6) is plainly at odds with the consensus reached by the Committee and should be deleted from the final rule. For the same reasons, index payors should not be required to pay royalty on gross proceeds from gas contract settlements entered into after the effective date of the rule, as an add-on to index payments and "true up" payments.

2. <u>Treatment of Downstream Gas</u> (§202.450(b) at 60 FR 26016)

At the end of §202.450(b), MMS has proposed to add the following sentence:

> However, except as provided in §202.451(b) [respecting the royalty-free use of gas to operate a processing plant], in no instances will any gas be approved for use royalty free downstream of the facility measurement point approved for the gas.

This provision was never considered by the Committee, nor does MMS explain why this prohibition was included in the proposal. Moreover, it may well contravene lease provisions which permit gas to be used royalty free for the benefit of the lease, and it seems to contradict the decisions of at least three federal district courts which invalidated attempts by the Department in the 1970's to assess royalties on gas used for lease purposes. *Amoco Production Co. v. Andrus*, 527 F. Supp. 790 (E.D. La. 1981); *Gulf Oil Corp. v. Andrus*, 460 F. Supp. 15 (C.D. Calif. 1978; *Marathon Oil Co. v. Andrus*, 452 F. Supp. 548 (D. Wy. 1978). The MMS should adhere to the decisions of the courts and not include the quoted sentence in its final regulations.

However, if the MMS believes that it now has authority to curtail the use of gas royalty free at a point downstream of a facility measurement point, the MMS should at least clarify the proposed sentence. As worded, the sentence is ambiguous and could be construed to prohibit royalty-free use of gas either at a location actually downstream of the facility measurement point or at any location (even on the lease) after the gas has flowed through the facility measurement point. Since the MMS could not intend to assess royalty on gas which flowed through a meter and was then returned to the lease, the MMS should clearly state in §202.450(b) that all gas used on a lease for production purposes is free of royalty.

3. <u>Zone Determination</u> (§206.454(g) at 60 FR 56027)

The Committee agreed that MMS should determine the eligible zones, after a technical conference, based on factors and conditions recommended by the Committee. However, the Final Report also states: "The committee recognized that this list of factors and conditions is <u>not necessarily all inclusive</u> when determining zones but represents a list of significant considerations in making this determination." *Final Report* at 52 (emphasis supplied).

We also note that the Committee voted on an initial list of zones as a single package, including a zone for the San Juan Basin. Although there was considerable discussion regarding the unique characteristics of coalbed methane production in the San Juan Basin, the Final Report and the proposed rule are silent on this important issue. Therefore, when making a final zone determination, the MMS should resolve this issue in a technical conference, giving further consideration to coalbed methane production because of its unique characteristics.

4. <u>Improved Benchmarks for Gas Sold Under Non-Arm's-Length Contracts</u> (Preamble at 60 FR 56009; §206.454 at 56023-56027)

The MMS notes that the Committee was unable to reach consensus on improved benchmarks for valuing gas sold under non-arm's-length contracts when the gas is not subject to valuation under an index-based method. The MMS states further that it will issue a separate rulemaking that will improve the existing benchmarks and requests suggestions from interested parties. 60 FR 56009.

The members of the negotiated rulemaking Committee had no difficulty agreeing that the existing benchmarks have failed to provide sufficient certainty to enable a lessee to correctly determine value when payment is due. "The majority of the problems surrounding the current benchmark system centered around the definition of comparable contracts and the lessee's inability to access such information." *Final Report* at 53. What the parties were unable to reach agreement upon was how the necessary certainty might be achieved. The MMS and the states proposed three benchmarks, two of which necessitated consideration of the proceeds received by a lessee's affiliate for reselling gas. *Id.* at 53-54. Industry proposed benchmarks which would enable the determination of royalty value based on information readily available to the lessee, but which did not include resales by a lessee's affiliate. *Id.* at 54-55.

API's members oppose any method which requires that value for royalty purposes be based on resales by a lessee's affiliate. First, the same considerations exist for non-arm's-length sales which justified an alternative to gross proceeds royalty valuation method for arm's-length sales, e.g., the impracticability of sourcing sales from pools back to individual leases, the administrative burden of calculating a weighted average price for all sales from a pool and then recalculating it each time retroactive adjustments are processed, legal uncertainty as to what downstream sale revenues are includable in gross proceeds and which costs are deductible from gross proceeds as transportation. Second, MMS' right to "pierce the corporate veil" in order to establish royalty value based on an affiliate's resale of gas is the subject of protracted litigation with no apparent end in sight. Thus, there is even more legal uncertainty and litigation risk associated with requiring a lessee to net back from an affiliate's gross proceeds than with requiring it to net back from its own arm's-length gross proceeds. Ironically, although willing to admit that valuation based on a lessee's own arm's-length gross proceeds is no longer appropriate in today's gas marketing environment, the MMS and the States appear intent on "improving" the non-arm's-length benchmarks by elevating the most controversial benchmark, i.e., netback from the gross proceeds of an affiliate's resale, from the last benchmark to the second benchmark, placing lessor and lessee on a near certain legal collision course.

API recommends the adoption of improved benchmarks similar to those contained in the "Industry Proposal" described in the *Final Report* at pages 54-55.

These benchmarks would establish royalty value based on information readily available to the lessee, arm's-length transactions with third parties. In addition, the "Industry Proposal" benchmarks would set forth clear guidelines for comparable sales.

5. Failure to Calculate the Final Safety Net Within Two Years (Preamble at 60 FR 56012; §206.454(e)(6) at 60 FR 56026)

At 60 FR 56012, the MMS states that the Committee did not address the consequences of MMS not publishing the final safety net median value within two years, and requests comment on the appropriate consequences, suggesting several options: (1) using the initial safety net median value; (2) having no additional royalty due; or (3) suspending interest until the final safety net median value is published. Once again, API believes the issue was addressed and that the MMS should adhere to the consensus of the Committee.

The record indicates that, during the protracted negotiations of the safety net calculation, industry participants were willing to true up index based royalty payments to a safety net median value, provided that the safety net was calculated expeditiously. Industry proposed that the calculation be based on MMS-2014 data existing six months after the end of the year. The six-month delay was suggested so that retroactive adjustments, the majority of which occur within six months after the initial report, could be included in the safety net calculation. The states argued that the safety net must be based on audited MMS-2014 data and insisted that the calculation be delayed until the MMS-2014 data reported by the gross proceeds payors could be fully verified and adjusted for audit exceptions. Industry maintained that any certainty to be achieved from an index-based valuation method would be lost if an indefinite time period were allowed within which to calculate the safety net value. MMS agreed with the states that the safety net calculation should be based on audited MMS-2014 data, but expressed sympathy for Industry's need for certainty. Maintaining that gross proceeds-based 2014's could be verified on an expedited audit schedule, MMS offered to audit gross proceeds based transactions and publish the safety net calculation within two years. The RMP Deputy Associate Director for Compliance was brought in, and he assured the Committee that verification could be accomplished within two years. A commitment was also made to continue to streamline the appeals process and use ADR to assure that appeals by gross proceeds lessees are decided by the Director within the two year period. Based on these assurances and commitments, the Committee reached consensus that a final safety net median value would be published within two years. *Final Report* at 34-35.

Lessees choosing the index method would be required to select the correct index, or indexes, calculate transportation allowances to the index pricing point, and report and pay royalties in a timely manner and any underpayment under an index methodology would be subject to interest, like any other underpayment. Thus, under the proposed rule, the index- based royalty payment is the correct royalty value until the final safety net value is published. Although a "snapshot" safety net value is published six months after the end of the index year based on unaudited 2014's, it is not the correct royalty value, and lessees are not required to use it to adjust index-based payments.

Given the facts surrounding the negotiation of the two-year period, it is surprising that MMS considers the consequences of failing to calculate the safety net within two years to be an issue which was not addressed by the Committee. All the MMS must do at the end of the two-year period is run the same computer program it ran when the "snapshot" was published. The only difference would be that the 2014 data will have been adjusted by gross proceeds payors as a result of audit exceptions. Thus, only a conscious decision not to run the program would prevent the MMS from publishing the final safety net median value. Having extracted from industry an agreement to true up to audited 2014's by representing that the final safety net median value would be published within two years, fundamental fairness requires that MMS not benefit from its failure to live up to its commitment. Allowing additional time so that more adjustments could be made by the gross proceeds payors would constitute breaking its commitment to Industry. Further, since it was the consensus of the Committee that "royalty value is the higher of the index value or safety net median value," if the latter does not exist because it has not been calculated, then the index value is the higher value. Thus, if the final safety net median value is not timely published, no additional royalty is due, and all additional royalty payments made in reliance on the earlier "snapshot" must be refunded. In no event should additional royalty be based on the "snapshot." Having spurned industry's proposal to base the safety net on unaudited 2014's in existence six months after the end of the index year, and extracting from Industry an agreement to wait another 18 months for royalty value to be determined, MMS should be estopped from using the "snapshot" if it fails to timely publish a final safety net median value.

6. Calculation of the Lessee's Weighted-Average Index-based Value
(Preamble at 60 FR 56012; §§206.454(e)(8), - (e)(9), and (e)(10) at 60 FR 56026-56027)

As proposed, §206.454 (e)(8), provides that:

> The lessee must determine the weighted-average index-based value for unprocessed gas and residue gas in the zone by summing the index-based values determined under this section, less applicable transportation allowances under §206.457, and dividing that sum by the total quantity of MMBtu's of unprocessed gas and residue gas in the zone.

This seems to conflict with the recommendation of the Committee that MMS calculate the lessee's weighted average index-based value: "For lessees who elected to pay on an index-based method, MMS will calculate the lessee's weighted average index price paid net of allowances for the index year by zone." *Final Report* at 35 (emphasis supplied). API, therefore, urges the MMS to publish a final rule with §206.454(e)(8) amended to reflect the consensus of the Committee. Similar corrections should be made to §206.454(e)(9) and §206.454(e)(10).*

7. Payment/Reporting Responsibility for 100 Percent Federal and Stand-Alone Leases (Preamble at 60 FR 56015)

As noted in the preamble at 60 FR 56015, the Committee concurred with an MMS proposal regarding payment and reporting of royalty on takes for agreements which contain 100 percent federal leases with the same royalty rate and fund distribution codes with an exception to seek approval for payment on an entitlements basis. The preamble, however, fails to mention that industry, in concurring with the MMS proposal, did not agree that a lessee is liable for underpayments on anything other than its entitled volume. The preamble also fails to state that the MMS proposal provided that all volumes taken could be reported to the lease from which the volumes were taken, and that MMS would internally reallocate production among the leases. API, therefore, urges the MMS to include the full proposal in the final rule to clarify these areas.

Sincerely,

G. William Frick

G.William Frick

* As proposed, §202.454(e)(9) (applicable to residue gas and NGL's) and §202.454(e)(10) (applicable to NGL's) both include a true up percentage of 50 percent, an apparent error. Corrected, §202.454(e)(9) should include a true up percentage of 65 percent and §202.454(e)10) should include a true up percentage of 30 percent.